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Group-Washington

March 1, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Chief
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers.*

On behalf of Pacific Bell, please find enclosed an original and six copies of its *"Reply Comments of Pacific Bell and Nevada Bell"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosures

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OFFICE OF SECRETARY

In the Matter of	)	
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Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
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REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: March 1, 1996

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Summary

Nobody has demonstrated that the long-term difference between the productivity of the LECs and the general economy has significantly exceeded 2%. The California Public Utilities Commission has largely accepted this position, recently deciding that the X factor should be set equal to the GDP-PI. The CPUC also rejected an input price adjustment. Finally, it recognized that there is "more than enough evidence" of competition "to support modification of price cap regulation and suspension of the Price Cap formula." The CPUC observed that "if one looks at the most relevant market, that for intraLATA toll" -- the market most recently opened to competitors, on January 1, 1995 -- "it is clear that [Pacific's] market share loss in California is both extraordinary and unprecedented."

The Commission acknowledges the X Factor should be "economically meaningful." But our competitors' proposed alternatives are economically meaningless. MCI contends the price cap formula should be used to "reinitialize LEC interstate access rates to their direct economic costs." Any rates set above "direct economic costs," says MCI, would "gouge their customers." If this were so, MCI itself could be said to have done its share of gouging. Few markets are characterized by the lush margins typical of the long distance business. In reality, however, MCI is espousing a crackpot theory. "Direct economic cost" may be an appropriate cost floor for detecting cross-subsidies or some other anticompetitive strategy. But that does not make it the right *price*. A product, like access, that we are required to sell wholesale to our competitors should be priced to recover at least the same contribution to overheads and other shared and common costs as the retail products it is displacing. Otherwise, retail buyers would receive distorted signals of our relative efficiency.

AT&T and others suggest that only "Interstate TFP" (suitably padded with an input price adjustment and a consumer productivity dividend) should be adopted. "Interstate TFP" would be as much a fiction as "separated costs" -- a political benchmark of sorts, but without any economic meaning. AT&T's Dr. Norsworthy's study is invalid, among other reasons, because he accepts as valid economic presumptions so many of the political presumptions that underlie the separations process.

AT&T also contends that adopting TFP would violate Section 152(b) of the Act and *Smith v. Illinois Bell.* AT&T has things backwards. Section 152(b) denies the Commission any jurisdiction to affect intrastate charges. *Smith* held that an intrastate charge could not be made to "bear an undue burden" through lack of apportionment of costs between the jurisdictions. But the Commission's adoption of TFP would in no way affect or burden intrastate charges.

Finally, the Commission requests comment on possible changes to the formula used to determine the Carrier Common Line Charge. This issue would be mooted if the Commission were to adopt TFP. In the alternative, any changes to the formula should be considered in the context of comprehensive reforms to universal service funding and access charges.

Before the
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In the Matter of	)	
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Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
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REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell (the "Pacific Companies") hereby file these reply comments on the Fourth Further Notice of Proposed Rulemaking in the above-captioned proceeding.[1]

Commenters have failed to demonstrate that the long-term difference between the productivity of the LECs and the general economy has been greater than about 2%. Nor has any party shown that a productivity ("X") factor greater than about 2% should be adopted.

Since our Comments were filed, the California Public Utilities Commission ("CPUC") has largely accepted this position, deciding that in the future the X factor should be set "equal to the prevailing rate of inflation by suspending the application of the Gross Domestic Product Price Index (GDPPI) minus productivity factor ("X") formula until completion of a future review to be conducted within three years."[2] We attach the CPUC's decision to these Reply Comments for this Commission to consider.

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[1] *In the Matter of Price Cap Performance Review for Local Exchange Carrier*, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, FCC 95-406 (released September 27, 1995).

[2] *Investigation re Second Triennial Review of Incentive-Based Regulatory Framework for Local Exchange Carriers*, CPUC D.95-12-052, mimeo, p. 2 (December 20, 1995).

I. The X Factor Should Be No More Than About 2%.

A. The "Correct" Number for Total Factor Productivity Is About 2%

With our Comments we filed the total factor productivity study of the local exchange industry that Dr. Laurits Christensen (who has also testified for USTA in this proceeding) presented to the CPUC in its triennial review of price cap regulation. In that study Christensen concluded that the long term TFP growth differential between the U.S. telephone industry and the U.S. economy was 2.1%. Because it was based on a long-term study, Christensen's recommendation to the CPUC is inherently more reliable than one based on any short-term study.

At the CPUC, Christensen's conclusions were challenged by Dr. Lee Selwyn of Economics and Technology, Inc. (who has testified for Ad Hoc in this docket). Among other things Selwyn testified that the X factor formula should include an input price differential and a "stretch factor" (*i.e.*, a consumer productivity dividend), for a total X of 5.7%. AT&T's experts also testified that the X factor should be no less than 5%.

In its decision, the CPUC carefully considered challenges to Christensen's study and overruled them. "While we are not convinced that a point estimate of a 2.1% TFP figure recommended by Dr. Christensen is the single 'correct' number," said the CPUC, "the consistency of this finding with the range of findings [of other productivity studies] causes us to conclude that the 'correct' TFP amount lies in a range between 1.8 and 2.6."[3]

With its comments in this proceeding, the United States Telephone Association ("USTA") filed a new "simplified" study by Christensen that is based entirely on public data, examines a shorter term than Christensen's CPUC study, and responds to other concerns of

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[3] *Id.* at p. 67.

the Commission.[4] With these differences, which result in a slightly higher TFP, the "simplified" Christensen study presents results that are entirely consistent with the CPUC's findings.

The best evidence supports an X factor of about 2%. If it must base the X factor on more volatile short-term data, the Commission should adopt the results of the Christensen study that was filed with USTA's comments.

Most of the parties who advocate a higher X factor can only justify it by padding the result of Christensen's study. AT&T, for example, which argues for an X factor of up to 8.8%, says that an input price adjustment, an interstate-only adjustment, and a consumer productivity dividend should be added to the results of any TFP study. We respond to AT&T's contentions below.

Quite apart from its technical flaws, AT&T's proposed X factor does not pass the "red face" test. It takes no calculator to see that an annual reduction of 8.8% would eliminate the majority of our revenues from interstate access in less than a decade. Moreover, since 8.8% far exceeds the actual productivity we have been able to achieve, in the long run (as all margin from access services is eliminated) it would be confiscatory.

In the same dubious category is AT&T's contention that the productivity factor recommended by USTA must not be high enough, because the "overwhelming majority of the price cap LECs selected an X-factor that substantially exceeded that produced by the USTA model." (AT&T, p. 26.) But *all* of the X factors available for "selection" were higher than that produced by the USTA model. We were given a Hobson's Choice. More important, since a majority of LECs chose the no-sharing option because a majority of LECs would

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4 This moots the objections of AT&T, Ad Hoc, and others. See for example AT&T, p. 9.

otherwise have been sharing, AT&T's argument reduces to saying that "if LECs are sharing, the X factor isn't high enough." There's another term for this: rate of return regulation. What X factors the LECs choose from the price cap plan has no probative value whatsoever.

B. There Should Be No Input Price Adjustment

A number of commenters, such as AT&T (p. 29) and Ad Hoc (p. 5), say that an input price adjustment (IPA) may be appropriate in the price cap formula. In support of such an adjustment, they point to short-run changes in input prices for the LECs that allegedly have been different from changes for the economy as a whole.

Even if true, however, this does not suggest that the price cap formula should include an IPA. As Christensen's data shows, past yearly changes in LEC input prices vis-a-vis the national economy have been random, highly volatile deviations from a mean of zero.[5] Such changes have no predictive value. Thus they have no place in a forward-looking price cap formula like the Commission's. They would also cause rate churn and create transactional uncertainty between carriers and customers.

The CPUC specifically rejected an input price adjustment:

> Finally, although we find the arguments of Dr. Selwyn on "input price differentials" theoretically interesting, we conclude that there is no basis for concluding that an empirical input price differential will exist in the next three years, or that it exists today.
>
> Indeed, the record contains substantial evidence that the input price diffrential between the telecommunications industry and the U.S. economy is zero. Dr. Christensen provided data on input price growth for the telephone industry and the overall economy for the years 1949 to 1922, and his analysis demonstrated that input prices for the telephone industry and the rest of the economy grew at virtually the same rate, with only a 0.05% difference. Further, Dr. Christensen testified that although Dr. Selwyn shows an input price differential for the 1984-1992 period, the

[5] See Comments of United States Telephone Association, filed January 16, 1996, Christensen Appendix 3.

> volatility of that period is so great that the observed differences are not statistically distinguishable from a difference of zero. This same conclusion is reached by Dr. Shmalensee and Dr. Duncan. Based on this record, there is no basis to conclude that the input price differential is different from zero. This result arises because the average of a highly volatile short-term input price differential provides a poor basis to predict future input price behavior.[6]

In conclusion the CPUC said, "We ... reject a productivity factor of 5.0% because it is outdated, no longer reflects today's markets and prices, and is inconsistent with the record. We further find that any use of a price-cap formula that includes an "X" factor of 5.0% is an unreasonable policy."[7]

C. Competition and the X-Factor

One reason the CPUC was concerned about an X factor as high as 5% is the interaction between the price cap formula and competitive entry. First, a productivity figure is a "double hit" to a carrier faced with competition. Such a carrier already must reduce prices to meet growing competition, before reducing overall prices in response to the price cap mechanism. Second, a regulated carrier's historical productivity growth is unlikely to be sustainable when competition is introduced, because the carrier is bound to lose revenues to competitors without avoiding costs.

In competitive markets, automatic productivity reductions are simply unnecessary, because competition provides the necessary price discipline. Yet current rules require the X-factor be applied uniformly to competitive and non-competitive services alike. For LECs subject to even a limited amount of competitive entry, the perverse effects of such

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[6] *Investigation re Second Triennial Review of Incentive-Based Regulatory Framework for Local Exchange Carriers,* CPUC D.95-12-052, at pp. 68-69.

[7] *Id.* at p. 69.

automatic, compounding productivity reductions are doubly crippling. They reduce price flexibility in competitive markets. And they reduce rates in noncompetitive markets where contribution to total costs is already low or even nonexistent. In these low- (or no-) margin markets they prevent needed rate rebalancing and deter competitive entry.

In his testimony to the CPUC, Christensen estimated that a one percentage point decrease in total output (revenue) will lead to a reduction in TFP growth of between .3 and .5 percentage points; a one percentage point decrease in intraLATA toll and switched access would lead to a reduction in TFP of about .21 percentage points.[8] Taylor and Taylor estimated that the loss of market share since 1984 reduced AT&T's annual volume growth to about two-thirds of what it would have been without the loss in share.[9]

The CPUC disagreed with those who contend that there is "very little definitive evidence" of "rapidly accelerating competition."[10] It said:

> Part of the problem carriers face in showing the level of competition in the telecommunications industry is that the most relevant evidence does not yet exist. The LECs cannot be faulted for the inability to provide evidence on the state of competition in 1996 and beyond comparable to evidence on past events. The LECs do, however, present evidence in the form of expert testimony on prospective evidence that is probative. Dr. Robert Harris cites the announced business plans of Pacific's competitors and credibly explains their significance. Evidence shows growth in competition from IECs, CAPs, and cable television companies; growth in competition from wireless voice and data services; as well as the particular vulnerability of LEC markets to entry targeted at lucrative geographical areas. This evidence is more than adequate to support taking actions to adjust the regulatory system to make it more compatible with current and

[8] *Investigation re Second Triennial Review of Incentive-Based Regulatory Framework for Local Exhange Carriers*, CPUC I.95-05-047, Dr. Christensen (for Pacific Bell) Exh. 1, Att., pp. 12-15 (September 8, 1995).

[9] William E. Taylor and Lester Taylor, "Postdivestiture Long-Distance Competition in the United States," American Economic Review, vol. 83 (1993), pp. 185-90.

[10] *Investigation re Second Triennial Review of Incentive-Based Regulatory Framework for Local Exchange Carriers*, CPUC D.95-12-052, at p. 40.

> imminent competition in the industry... [Although opponents] describe Dr. Harris' testimony as being general, speculative, and a miscellany of diverse statistics, anecdotes, press releases, and newspaper reports, these pieces of information ... are the life blood of market intelligence and expert projections....
>
> "Effective competition" is not a prerequisite for modifying the price cap formula. The threshold question is whether competition has increased to such a point as to cause us to reconsider the continued application of the price cap formula ... At this time, there is more than enough evidence to support modification of price cap regulation and suspension of the Price Cap formula. The fact that the LECs face more competition in the toll markets today and that once the remaining local markets are opened, the degree of competition will further increase, are strong indicators of the moement towards a more competitive market. Modification of price cap regulation through suspension of the price cap formula is necessary.[11]

The CPUC observed that "if one looks at the most relevant market, that for intraLATA toll" -- the market most recently opened up to competitors, on January 1, 1995 -- "it is clear that the market share loss in California is both extraordinary and unprecedented."[12] It said, "We expect that competitive actions will arrive in bursts, will appear in various geographic areas before others, and will target specific services. In other words, there will be dynamic change in the industry.... Our regulatory framework must reflect this change."[13]

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[11] *Id.* at pp. 40-41, 43, 48-49.

[12] *Id.* at p. 47.

[13] *Id.* at p. 51.

II. The X Factor Is Not Supposed to Drive Access Rates Down to "Economic Cost"

MCI seeks an entirely new rationale for price cap regulation. It says that the Commission should not use a TFP approach for setting the X factor, but that if it does "use a TFP-based method for setting the X-factor because it believes that is the more economically relevant measure of productivity changes, then it must first also reinitialize LEC interstate access rates to their direct economic costs, because these are the more economically relevant costs than the LECs' embedded costs of providing access. " (MCI, p. 2.) "Economic principles can not be followed in one case but forgotten in the other," it adds. Otherwise, the LECs would "gouge their customers with rates that are set well above their direct economic cost." (MCI, pp. 2-3.)

As a matter of logic, this is a *non sequitor*. As a matter of economics, it is pure bosh. TFP is the most widely accepted way to measure the productivity of a total enterprise. However, TFP implies nothing about the costs (therefore, profits) of *individual services*. The analogy that MCI makes between using TFP for the X factor and using "direct economic cost" to set service prices is simply false.

If "direct economic cost" means the incremental cost of a service, it may be "relevant" to some purposes -- but not all. Incremental cost maybe an appropriate cost *floor* for detecting cross-subsidies or some other anticompetitive behavior. But that does not mean it is the right *price*. A firm that prices all of its services at their incremental costs is not "economically correct." It is on its way to insolvency.[14] Surely MCI knows this. In most if

[14] See our Reply Comments filed in response to the *Second Further Notice* in this docket, pp. 20-21.

not all cases, its prices are set above "economic costs," or it would never have succeeded as a business. Perhaps *far* above "economic costs." The most recent full year income statement (for 1994) that AT&T Communications of California, Inc. filed with the CPUC reported a rate of return on its intrastate ratebase of 43.35%. Because its basic pricing strategy is still to imitate AT&T's price structure and discount AT&T's prices (albeit fractionally), MCI's rate of return is unlikely to be very different. When MCI prices above "economic cost," why is it not "gouging"?

The fact that MCI competes with us does not justify reducing access prices to their incremental costs. In fact, it would be particularly inappropriate to impose a price ceiling of incremental cost on a product, such as access, that we wholesale to our competitors. Every good businessperson knows that the price of a wholesale product should include at least the same contribution to shared and common costs as the price of the retail product it replaces -- otherwise, the wholesale business is harming, not helping, the firm.

It would be patently anticompetitive for the Commission to require us to provide wholesale services such as access to our competitors at incremental cost. First, it would enable our competitors simply to expropriate the contribution formerly made by our wholesale product to shared and common costs. This problem would be especially acute for us, since some of our services are required to be priced below cost. Second, by forcing our retail product to absorb all of those shared and common costs, it would disadvantage us in the retail market. Inefficiency would result -- assuming we were not forced to exit the business completely -- because downstream buyers would receive distorted price signals.

III. "Interstate" TFP Does Not Exist, and Should Not Be Fabricated.

AT&T, MCI, Ad Hoc, Ameritech, and NYNEX, suggest that an interstate allocation of costs may be appropriate for determining the X factor. "Interstate TFP" is an oxymoron: the "T" in "TFP" stands for "total." One of the reasons TFP is "economically correct" (as MCI says) is that it removes the arbitrary effects of separations, depreciation rates, and other accounting phenomena. "Separated costs" is, if not an oxymoron, a legal fiction. As the courts have observed, the separations manual is a book of political principles, not economic ones.[15] What emerges from the separations process is *not* a cost in the economic sense. To the extent the X factor is supposed to be "economically meaningful," as the Commission says (*Fourth Notice*, para. 16), it cannot be based on changes in *separated* "costs."

AT&T and MCI do not openly dispute this. Their arguments are circular and have no rational basis. MCI says,

> If LEC productivity in providing interstate access services is greater than total company productivity, as appears to be the case based on the record to date in this docket, use of a total company TFP-based X-factor will result in interstate rates which are too high.... a TFP approach is not likely to cause interstate access prices to fall to at least the same degree that a LEC experiences productivity gains for interstate service, i.e., the LEC experiences a windfall.... The price cap plan system caps only interstate rates. The price cap plan must therefore cap rates based on changes in LEC interstate costs.

(MCI, pp. 2, 8.) In similar fashion, AT&T refers to the Commission's observation that there is "higher apparent interstate productivity growth" than intrastate (AT&T, p. 14, emphasis omitted, citing *LEC Price Cap Order,* 5 FCC Rcd 6786, para. 92). AT&T says that its

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[15] See *National Ass'n of Regulatory Util. Comm'rs v. FCC,* 737 F.2d 1095 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985).

consultant Dr. Norsworthy "demonstrates that the productivity growth in the LECs' interstate services can be separately measured." (Id.)

These statements prove nothing. MCI's contention is a tautology: it merely contends that separated costs would result in a higher interstate productivity factor; therefore separated costs must be used, or LECs will receive a windfall. As for AT&T, it has quoted the *LEC Price Cap Order* out of context. The Commission staff there acknowledged that the "apparent" difference in interstate productivity may be an artifact of the separations process: "if some costs were divided in fixed proportions but recovered on the basis of use" -- consider common line costs -- "then the jurisdiction with a more rapid rate of growth would *appear* more productive."[16]

Dr. Norsworthy also proves nothing, because he accepts as valid *economic* presumptions so many of the *political* presumptions underlying the separations process. His study uses separated revenue requirements (pp. 17, 23 n.9, 29). He assumes that there is something called "interstate access services" -- which often, in the real world, is not the case. Switched and special "interstate access services" are generally integrated with intrastate access services. They share facilities and thus costs. Some of those costs are non-traffic sensitive, and must be allocated by *fiat*. For example, all of the costs and revenues of a special access circuit are deemed interstate if ten percent or more of the usage is. To the degree he uses separated revenues or revenue requirements, Norsworthy's results are thereby distorted. Moreover, one service that Norsworthy falsely assumes is *not* interstate is loop service. He includes no revenues from end user lines in his estimations of output -- only

[16] See 5 FCC Rcd 6786 (1990), App. D, para. 4 (emphasis added).

revenues from usage products. In addition, he appears to estimate capital in the grossest way -- as the residual of labor and materials -- leading to wild swings in the price of capital from one year to the next. Norsworthy's study is a farrago of arbitrary assumptions and illogical shortcuts.

Consistent with Norsworthy's reliance on separated data, AT&T contends that determining the productivity factor by changes in *total* company revenues and costs would violate Section 152(b) of the Act. (AT&T, p. 15.) The argument sounds ominous, but it is lightweight. Section 152(b) denies the Commission any jurisdiction over intrastate charges. AT&T reads Section 152(b) backwards -- as if it limited the Commission's authority over *interstate* charges. Adopting a productivity factor based on total costs would not violate Section 152(b) because it would not, in any way, affect any "charges, classifications, services, facilities, or regulations, for or in connection with intrastate communications service."[17]

AT&T says that using TFP would be contrary to *Smith v. Illinois Bell.* But *Smith* is no more relevant to these issues than Section 152(b). The holding of *Smith* was that an *intrastate* rate would "bear an undue burden" if no apportionment between the jurisdictions were made by the state commission. "The question presented in the present case is ... of alleged confiscation through prescribed intrastate rates."[18]

Smith preceded the Communications Act. Its holding led directly to Sections 152(b) and 410 of the Act. 152(b) bars the Commission from making intrastate rates "bear an undue burden" (in the words of *Smith*); Section 410 of the Act provides the "apportionment" that was lacking in *Smith.* Both sections were necessary to effect the holding of *Smith,*

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[17] 47 U.S.C. Section 152(b).

[18] *Smith v. Illinois Bell,* 282 U.S. 133, 152 (1930).

because the separations process, by its nature, "burdens" intrastate rates. In light of Sections 2(b) and 410 of the Act, which have superseded it, the exact relevance of *Smith* today may be, as the D.C. Circuit acknowledged, "perplexing,"[19] but its holding certainly would not preclude adopting TFP. *State rates will not be "burdened" by the Commission's decision.*

IV. The X Factor Should Be Based On Economic Depreciation Rates

In the *Fourth Notice,* the Commission asked whether the appropriate depreciation rates in a TFP study should be "'economic' depreciation rates, rather than the depreciation rates prescribed by the Commission." (*Fourth Notice,* para. 37.) MCI (pp. 17-19), AT&T (p. 22), and Ad Hoc (Appendix, pp. 20-23) enthusiastically support the use of Commission-prescribed depreciation rates.

The Commission's depreciation rates, "simplified" though they recently were, have never been useful as a basis for determining economic costs. Like the separations rules, the rates had a different purpose entirely. As the Commission observed in 1992:

> Our current process for determining depreciation rates was born during the 1940's when there was no competition and little technological change in the telephone market. This process was refined over a period in which the Commission regulated telephone earnings on a rate of return/rate base basis. A keen regulatory eye was necessary to ensure "reasonable charges" to ratepayers.
>
> However, since this depreciation prescription process was put into place, the telecommunications industry has experienced considerable change. We now have significant competition in the interexchange market, emerging competition in the local exchange market, and more rapidly changing technology. We have recognized these changes, and have put in place a price cap regulatory plan designed to provide the incentives that occur in a competitive market. Our price cap plan encourages carrier efficiency without allowing them to pass depreciation expense changes onto ratepayers.[20]

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[19] *Illinois Bell Tel. Co. v. FCC*, 883 F.2d 104, 114 n.9 (D.C. Cir. 1989).

[20] *Simplification of the Depreciation Prescription Process,* 8 FCC Rcd 146 (1992), paras. 7, 8.

This eloquently states the case against using Commission-prescribed depreciation rates to determine an X factor that is "economically meaningful." (*Fourth Notice,* para. 16.) It would also be arbitrary to require the X factor to be based on Commission-prescribed depreciation rates, while denying carriers the opportunity "to pass depreciation expense changes onto ratepayers."

V. Changes to the Common Line Formula Should Not Be Considered Except in a Comprehensive Proceeding

As it modifies the price and output controls to which our interstate access services are subject, the Commission will need to make changes to both Parts 61 and Part 69 of its rules. In this docket (which it has already subdivided into Second, Third, and Fourth Further Notices of Proposed Rulemaking), it will consider changes to Part 61, governing overall access price levels and pricing flexibility. In a forthcoming proceeding, it will have to consider complementary "changes in our access charge rules [*i.e.,* Part 69], which govern the pricing and rate structures applicable to interstate access services."[21] We recognize that this arbitrary division into two tracks -- one for Part 61, another for Part 69 -- may be a practical necessity. However, certain issues the Commission has raised in this docket should not be considered in isolation. This includes potential changes to the carrier common line formula.

The carrier common line charge (CCLC) recovers in switching charges costs that are caused by customers for loop service. The charge was intended to subsidize one customer class at the expense of another. As alternative providers of switching service proliferate, and our switching charges begin to exceed the market price, the subsidy will

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[21] *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers,* CC Docket No. 95-185, Notice of Proposed Rulemaking, FCC 95-505 (released January 11, 1996), para. 17.

become unrecoverable. The distorting effect of the subsidy is compounded by the requirement to charge a usage-sensitive rate, even though loop costs are non-usage sensitive. As Economists are fond of saying, when something cannot go on, it will stop. In this case uneconomic bypass of our switches will take place, loop costs as well as switching costs will go unrecovered, and consumers as a whole will be worse off than before. Merely changing the common line formula, as the Commission proposes to do in this docket, would be like shifting deck chairs on the *Titanic.*

The ideal solution to the subsidy issue -- which we have described in our pleadings in the pricing flexibility round of this docket, and in Docket 80-286 -- is a comprehensive reform of universal service funding mechanisms. In the meantime, the common line basket and switching baskets should be given the same zone pricing flexibility as trunking, and LECs should be allowed to recover any residual carrier common line charges by more cost-causative means, such as non-usage sensitive charges.

In any event, if the Commission adopted TFP, the issue of the CCLC formula would become moot. We therefore oppose Sprint's proposal to cap the CCLC revenue per line. The current common line formula and other price cap mechanisms already limit the effects of revenue growth on the LECs. In addition, we face competitive loss of access lines and access minutes due to competition. In California, loop resale and unbundling has already begun. Artificially limiting the CCLC revenues on a per-line, rather than a per-company basis could further erode explicit universal service support mechanisms, at a time when implicit support to loop costs from other services is also being eroded. Because of growing competition, AT&T's proposal to base CCLC rates on 8-year averages of historical growth also makes no sense, indeed, seems explicitly designed to handicap us. It should not be adopted.

VI. All Exogenous Costs that Affect Cash Flow Should Be Recoverable

The Commission requests comment on whether it should limit exogenous cost treatment to Commission-ordered changes that result in shifting costs between the interstate and intrastate jurisdictions, or between regulated and non-regulated accounts. (*Fourth Notice*, para. 141.) The Commission has already modified its exogenous cost rules to deny exogenous treatment for accounting rule changes that do not affect a carrier's discounted cash flow. (*Id.* at para. 138.)

The treatment of exogenous costs should be rational and consistent. The belt-and-suspenders approach that MCI suggests -- limiting exogenous cost treatment to changes that result in jurisdictional cost shifts, *and* limiting treatment to cash-flow effects -- is irrational and inconsistent. Competitive enterprises usually have the ability to reflect the cash-flow effects of exogenous events in their prices. For example, when the American Public Communications Council recently proposed to exempt its members' payphone lines from end user common line charges, with the difference to be made up by higher carrier common line charges to IXCs, the IXCs properly objected that the higher charges would be passed through to end users.[22] That is because changes in the CCLC rate are exogenous changes that affect all IXCs.

Price cap regulation is supposed to simulate the effects of competition. As long as interstate earnings and other accounting phenomena do not affect our price caps, then limiting price cap adjustments to the cash-flow effect of exogenous events is defensible. (Likewise, we have cautioned that to the degree interstate earnings and other accounting

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[22] See, for example, Comments of MCI, pp. 1-2, in RM 8723, *Amendment of Section 69.2(m) and (ee) of the Commission's Rules to Include Independent Public Payphones Within the "Public Telephone" Exemption from End User Common Line Access Charges.*

phenomena *are* required to affect our prices, then the full effect of accounting changes should be recoverable.) But it is irrational to go beyond this, as MCI does, and contend that only *some* exogenous events that affect cash flow should be recoverable. That would be little different -- in the days when AT&T's domestic services were still subject to price caps -- of requiring AT&T to flow through changes in common line costs, but not switching costs. We ask nothing more than an all-or-nothing approach. If an event is exogenous (*i.e.*, it is caused by administrative, legislative, or judicial requirements beyond our control); and it is not otherwise recovered in the price cap formula (for example, through the GDP-PI or X factor); then its effect on our cash flow should be recoverable through an adjustment to our price caps.

VII. Conclusion

For these reasons, we urge the Commission to act in accordance with our recommendations.

Respectfully submitted,

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APPENDIX A

COM/HMD/JLN/jaw

Decision 95-12-052 December 20, 1995

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's Own Motion Into the Second Triennial Review of the Operations and Safeguards of the Incentive-Based Regulatory Framework for Local Exchange Carriers.	I.95-05-047 (Filed May 24, 1995)

(See Appendix A for appearances.)

INTERIM OPINION

Summary

In this decision, we find that the 5% productivity factor for Pacific Bell is inappropriate for the next three years primarily because the underlying assumptions and data on which the 5% rate was based are obsolete. Similarly, we find that the 5% productivity factor for GTEC is inappropriate for the time period following the expiration of the settlement entered into by GTEC.[1] However, we also find it premature to eliminate the price cap formula at this time. We further find that productivity

[1] For 1996, a settlement entered into by GTEC adopts this approach. We invite GTEC to file a petition to modify D.93-09-038.